RECORD AND BRIEFS

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Supreme Court, U.S.
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No. 10-1218

In the Supreme Court of the United States

VANESSA SIMMONDS,

Petitioner,

v.

CREDIT SUISSE SECURITIES (USA) LLC, ET AL.,

Respondents.

IN RE SECTION 16(b) LITIGATION

On Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

PETITIONER'S REPLY BRIEF*

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This appeal relates to the appeal previously docketed as No. 10-1261

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TABLE OF CONTENTS

TABLE OF AUTHORITIES ii

INTRODUCTION 1

DISCUSSION 1

I. REVIEW IS NECESSARY TO DECIDE IMPORTANT QUESTIONS OF NATIONAL IMPORTANCE FUNDAMENTAL TO PROPER SECTION 16 ENFORCEMENT. . 1

II. THE NINTH CIRCUIT DECISION CREATES REAL AND SERIOUS JURISDICTIONAL SPLITS IN BASIC SECTION 16 JURISPRUDENCE. 3

III. THE NINTH CIRCUIT DECISION TO DISMISS "WITH PREJUDICE" FOR PRE-SUIT DEMAND INADEQUACY CONFLICTS WITH FIRST CIRCUIT PRECEDENT. 6

CONCLUSION 9

TABLE OF AUTHORITIES

CASES

Allis-Chalmers Mfg. Co. v. Gulf & W. Indus., Inc.,
527 F.2d 335 (7th Cir. 1975) 4

Blau v. Mission Corp.,
212 F.2d 77 (2d Cir. 1954) 5

Costello v. United States,
365 U.S. 265 (1961) 7

Dottenheim v. Murchison,
227 F.2d 737 (5th Cir. 1956) 5

Foremost-McKesson, Inc. v. Provident Secs. Co.,
423 U.S. 232 (1976) 4, 5

Gollust v. Mendell,
502 U.S. 115 (1991) 5

González Turul v. Rogatol Distrib., Inc.,
951 F.2d1 (1st Cir.1991) 7

Grossman v. Johnson,
674 F.2d 115 (4th Cir. 1982) 5

In re Kauffman Mut. Fund Actions,
479 F.2d 257 (1st Cir. 1973) 6, 9

In re Sonus Networks, Inc.,
499 F.3d 47 (1st Cir. 2007) 6, 7, 8

Kamen v. Kemper Fin. Servs., Inc.,
500 U.S. 90 (1991) 3

Kern County Land Co. v. Occidental Petroleum Corp.,
411 U.S. 582 (1973) 5

Magma Power Co. v. Dow Chem. Co.,
136 F.3d 316 (2d Cir. 1998) 2, 5

Reliance Elec. Co. v. Emerson Elec. Co.,
404 U.S. 418 (1972) 1, 4, 5

STATUTES

15 U.S.C. § 78p(a) [Section 16(a)] ..... *passim*

15 U.S.C. § 78p(b) [Section 16(b)] ..... *passim*

RULES

Rule 23.1 ..... *passim*

OTHER AUTHORITIES

18A *Federal Practice & Procedure* § 4437 8

William L. Cary, *Recent Developments in Securities Regulation*, 63 COLUM. L. REV. 856 (1963) 5

Peter Romeo & Alan Dye, SECTION 16 (3d ed. 2008) 4, 5

Byron D. Woodside, *Resume of the Report of the Special Study of Securities Markets and the Commission's Legislative Proposals*, 19 BUS. LAW. 463 (1964) 5

INTRODUCTION

The circuits are split on whether Rule 23.1 derivative law informs Section 16(b) jurisprudence. The circuits are split on the effect of a dismissal on demand adequacy grounds. The questions Petitioner presents regarding the Section 16(b) pre-suit demand requirement involve fundamental issues about the proper interpretation of this critically important insider trading legislation. A decision from this Court will provide needed uniform guidance on basic questions about Section 16(b) enforcement. Review should be granted.

DISCUSSION

I. REVIEW IS NECESSARY TO DECIDE IMPORTANT QUESTIONS OF NATIONAL IMPORTANCE FUNDAMENTAL TO PROPER SECTION 16 ENFORCEMENT.

In their separately filed Petition for Writ of Certiorari, the Underwriters argue that decisions from the Ninth Circuit can provide a "*de facto* nationwide rule" as to important aspects of Section 16(b) jurisprudence. Pet. at 22 (No. 10-1261). If the Ninth Circuit decision is allowed to stand as such a "nationwide rule" on pre-suit demand issues, then Section 16(b) will be rendered impotent in carrying out its fundamental purpose "to curb the evils of insider trading." *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 422 (1972). The Ninth Circuit decision effectively immunizes those insiders in closest privity to material inside information, who intend to use that information to profit through short-swing trading in issuer securities. As occurred here, insiders seeking to

use inside information to reap short-swing, risk-free profits with impunity need only disguise their beneficial ownership of securities in customer or other accounts—with profit-sharing arrangements in place—and then ignore the disclosure requirements of Section 16(a). Such "novel and complex"[1] deception will almost always deprive the issuer's outside shareholders (like Petitioner) of the information that the Ninth Circuit now requires in a Section 16(b) pre-suit demand.

The Ninth Circuit decision, moreover, rewards insiders who engage in this type of deceptive conduct. The decision gives insiders standing to seek dismissal by challenging demand adequacy even where, as here, the insider has failed to file Section 16(a) reports and the shareholder has, as a result, been forced to piece the claim together from disparate and limited sources of information. Ironically, the decision effectively limits Section 16(b) to the rare instances involving "technical violators of pure heart"—those insiders who: (a) inadvertently or unintentionally engaged in transactions covered by Section 16(b); and (b) complied with their Section 16(a) reporting obligations. *Magma Power Co. v. Dow Chem. Co.*, 136 F.3d 316, 320 (2d Cir. 1998) ("Section 16(b) operates mechanically, and makes no moral distinctions[.]").

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[1] Moving Issuers characterize Petitioner's "theory of liability" as "novel and complex." Resp. Br. at 15. However, the theory of liability—disgorgement of profits obtained by statutory insiders through short-swing trades in issuer securities—is straightforward. What is "novel and complex" about this case are the unusual methods Underwriters employed to disguise their beneficial ownership interests in the targeted short-swing trades. *See* Pet. at 7-10.

II. THE NINTH CIRCUIT DECISION CREATES REAL AND SERIOUS JURISDICTIONAL SPLITS IN BASIC SECTION 16 JURISPRUDENCE.

Moving Issuers exalt form over substance in contending that the Ninth Circuit decision does not creating splits of authority on the question whether Rule 23.1 derivative law governs Section 16(b) demand sufficiency. The Ninth Circuit itself noted the conflict in the circuits. Pet. App. A at 51a n.7. The court then stated that the conflict was not relevant to its analysis. *Id.* However, what the Ninth Circuit stated in the footnote, and the actual analysis that the Ninth Circuit performed, are quite different. The main cases on which the Ninth Circuit relied in supporting its view of Section 16(b) demand adequacy are all Rule 23.1 cases in which the fundamental purpose behind Rule 23.1 inherently permeated the courts' analyses.

Section 16(b) and typical derivative actions are materially different in their design, purpose, and legal origin. Section 16(b) creates a primary, not a derivative, right of action. The business judgment of an issuer's board—a fundamental precept of derivative litigation—is antithetical to Section 16(b) enforcement. The demand requirement for a Section 16(b) claim, moreover, is stated explicitly in the statute. There is no "gap" to be filled by reference to Delaware or any other state law. *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 108 (1991).

The question what must be contained in a Section 16(b) demand when the insider has failed to file a Section 16(a) report—one of the pertinent questions here—should be addressed not by resort to state

derivative law as the Ninth Circuit did, but by assessing considerations relevant to Section 16(b), *e.g.*, the purposes of the statute, the overall legislative scheme Congress enacted with Section 16, and the significant disadvantage an outside-shareholder has when the targeted insiders fail to comply with their Section 16(a) reporting obligations. *See also Reliance Elec.*, 404 U.S. at 424 (Section 16(b) terms must be construed to "best serve[] the congressional purpose of curbing short-swing speculation by corporate insiders").

One consequence of incorporating Rule 23.1 to govern Section 16(b) demand sufficiency, as the Ninth Circuit has done, is that now a shareholder must describe alleged "wrongdoing" in a demand—***even though "wrongdoing" is not a requirement of a Section 16(b) claim***. Section 16(b) is a strict liability statute. *Foremost-McKesson, Inc. v. Provident Secs. Co.*, 423 U.S. 232, 251 (1976). It does not proscribe the practice of short-swing insider trading. It merely requires those statutorily designated insiders who receive a pecuniary benefit from short-swing trades to disgorge any profits from such trades. *See Reliance Elec.*, 404 U.S. at 422; *Allis-Chalmers Mfg. Co. v. Gulf & W. Indus., Inc.*, 527 F.2d 335, 357 (7th Cir. 1975). The short-swing trades themselves are not "illegal," and there is no Section 16(b) claim if the trades do not generate profits. Peter Romeo & Alan Dye, SECTION 16 § 9.01 (3d ed. 2008). Nor has there ever been a requirement of establishing "wrongful" conduct to state a Section 16(b) claim:

> Section 16(b) is a "blunt instrument" that is "about as subtle as a sledge hammer." The provision is notorious because it imposes strict

> liability on the basis of an objective standard intended to be applied in an automatic, mechanical fashion, without regard to the insider's motive or intent. All that is necessary to establish liability is evidence of insider status and a profitable short-swing transaction. No proof of actual misuse or inside information or bad faith on the insider's part is required.

Id. § 9.01[4] (footnotes omitted) (citing 15 U.S.C. § 78p(b); *Gollust v. Mendell*, 502 U.S. 115, 122 (1991); *Foremost-McKesson*, 432 U.S. at 251; *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 595 (1973); *Reliance Elec.*, 404 U.S. at 424 n.4; *Magma Power*, 136 F.3d at 320; Byron D. Woodside, *Resume of the Report of the Special Study of Securities Markets and the Commission's Legislative Proposals*, 19 BUS. LAW. 463, 476 (1964); William L. Cary, *Recent Developments in Securities Regulation*, 63 COLUM. L. REV. 856, 858 (1963)).

The Ninth Circuit decision is substantively grounded in Rule 23.1 law, notwithstanding the court's stated intention not to do so. The Fifth, Fourth, and Second Circuits hold that Rule 23.1 does not apply to Section 16(b), and have not similarly relied on Rule 23.1 substantive analysis to support a Section 16(b) decision. *Dottenheim v. Murchison*, 227 F.2d 737, 738 (5th Cir. 1956); *Grossman v. Johnson*, 674 F.2d 115, 120 (4th Cir. 1982); *Blau v. Mission Corp.*, 212 F.2d 77, 79 (2d Cir. 1954). The conflict is real—and for the reasons set forth herein and in the petition—the conflict has serious consequences on the ability of shareholders to enforce Section 16 as Congress intended. This is especially true when, as here, the insiders have failed to disclose both their group status

and short-swing transaction details as required under Section 16(a).

III. THE NINTH CIRCUIT DECISION TO DISMISS "WITH PREJUDICE" FOR PRE-SUIT DEMAND INADEQUACY CONFLICTS WITH FIRST CIRCUIT PRECEDENT.

Moving Issuers argue that Petitioner "manufacture[d]" a circuit split between the Ninth Circuit and the First Circuit on whether the dismissal should have been with or without prejudice (assuming demand inadequacy). Resp. Br. at 26. Moving Issuers' argument boils down to this: the Ninth Circuit stated it agreed with the First Circuit in *In re Kauffman Mut. Fund Actions*, 479 F.2d 257 (1st Cir. 1973); therefore, there must not be a conflict. However, the Ninth Circuit held that Petitioner's complaints were dismissed with prejudice. Under the First Circuit approach, the decision to dismiss on account of a precondition to suit, such as demand, is only dismissed "with prejudice" on the very issue litigated (in *Kauffman*, demand futility; here, demand adequacy). Dismissal is "without prejudice" ***as to all other demand issues***. For example, the plaintiffs in *Kauffman* were free to serve a demand and bring a second lawsuit. The First Circuit simply precluded the plaintiffs from filing the second suit without first serving a demand, so as to prevent relitigation of demand futility.

The First Circuit approach is further exemplified in *In re Sonus Networks, Inc.*, 499 F.3d 47 (1st Cir. 2007). In *Sonus Networks*, the First Circuit reaffirmed *Kauffman* and held that a Massachusetts state court

dismissal of a derivative action on demand futility grounds (specifically, a dismissal "without leave to amend") does not preclude a plaintiff from filing a second derivative suit upon satisfying the demand requirement. *Sonus Networks*, 499 F.3d at 55, 59-62. It merely means that the plaintiff is precluded from filing a second derivative suit and contending that serving a demand would be futile:

> While dismissal of a derivative suit for failure to plead demand or excuse [futility] is of course a type of dismissal for inadequate pleadings, it is also a dismissal for failure to accomplish a precondition, which is ***a failure that may be remedied by the time the second suit is filed***. The Supreme Court's decision in *Costello v. United States,* 365 U.S. 265, 285-88 (1961), confirmed that ***dismissal for failure to satisfy a precondition to suit should not bar a subsequent suit in which the defect has been cured***. . . . We acted consistently with this principle in *González Turul v. Rogatol Distributors, Inc.,* 951 F.2d .1 (1st Cir.1991). There, we reversed a judgment after trial in a derivative suit because the plaintiff had not alleged in the complaint either that she had made demand on the directors or that demand would have been futile, *id.* at 1; however, ***we dismissed the complaint "without prejudice,"*** *id.* at 3, ***with the implication that suit could be refiled*** if the plaintiff complied with Rule 23.1. . . . We therefore conclude that dismissal for failure to plead demand under Rule 23.1 is not entirely analogous to dismissal for failure to state a claim. ***We do not believe that applying***

> ***claim preclusion to a dismissal for failure to plead satisfaction of a precondition to suit is compatible with the principle of* Costello *. . . that failures to satisfy preconditions generally can be cured.***
>
> The defendants contend that the dismissal was on the merits in the sense of reaching a substantive issue . . . . The preclusive effect of a dismissal for failure to comply with a precondition to suit does not depend on whether the precondition is "substantive" or "procedural," but on whether the plaintiff has satisfied the precondition between the dismissal of the first suit and the filing of the second. *See* 18A *Federal Practice & Procedure* § 4437, at 184–85 ("Dismissal for failure to satisfy a procedural precondition should be treated in the same way as dismissal for failure to satisfy substantive preconditions. ***The dismissal is not an adjudication on the merits that would bar assertion of the same claim after satisfying the precondition . . . but it should preclude relitigation of the same precondition issue.***").
>
> In sum, we hold that the Massachusetts state court judgment was "on the merits" in the sense that it is entitled to issue-preclusive effect, but ***we reject the defendants' argument that the Rule 23.1 dismissal was "on the merits" in the sense that no further suit could be brought on the same claim.***

Id. at 61-62 (emphasis added).

In the event Petitioner's demand is deemed inadequate despite the insiders' failure to file Section 16(a) reports, Petitioner should be free to either: (a) serve substantively new demands; or (b) file a new complaint alleging demand futility. Litigation of either issue in a second lawsuit would not involve relitigating any issue decided herein. Moving Issuers appear to be in accord with Petitioner at least as to Petitioner's right to file a new complaint alleging demand futility. *See* Resp. Br. at 26 (describing effect of *Kauffman* dismissal).

CONCLUSION

Petitioner respectfully requests that this Court grant her petition and review this matter.

Respectfully submitted,

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